No. 94, Original

IN THE

Supreme Court of the United States

OCTOBER TERM, 1986

STATE OF SOUTH CAROLINA,
Plaintiff,

NATIONAL GOVERNORS' ASSOCIATION,
Plaintiff-In-Intervention,

v.

JAMES A. BAKER, III, SECRETARY OF THE TREASURY OF THE UNITED STATES OF AMERICA,
Defendant.

BRIEF OF THE PUBLIC SECURITIES ASSOCIATION AS *AMICUS CURIAE* IN SUPPORT OF THE PLAINTIFF AND THE PLAINTIFF-IN-INTERVENTION

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INTEREST OF *AMICUS CURIAE*

The Public Securities Association ("PSA") is a national trade organization of approximately 300 members, predominantly broker-dealers and banks, who are active participants in the capital market for State and local debt obligations, commonly referred to as municipal bonds. PSA's members underwrite more than 95 percent of the new issues of municipal bonds sold publicly in the United States each year. Its members are also active participants, as broker-dealers, in

secondary market activity. PSA's members frequently serve as financial advisors to State and local governments in the structuring, sale and delivery of municipal bond issues. Among PSA's stated purposes and an important focus of its activities is the preservation of a stable, efficient and orderly municipal bond market directed toward meeting the financial needs of State and local governmental issuers.[1]

As the Special Master noted in the Report, the municipal bond market is both large and varied. Report at 20-23. There are approximately 47,000 issuers of municipal bonds, ranging in size from the largest States to the smallest school districts. Bonds are issued to meet immediate cash-flow needs and to finance all manner of public facilities and programs. The ability of State and local governments to borrow is essential; indeed, it is inextricably related to their ability to function as governments providing the public services and capital projects required and expected by their citizens.

State and local borrowing needs have grown substantially in recent years and will continue to grow in the future. In 1983, the volume of new long-term issues of municipal bonds was in excess of $83 billion. Report at 20. By 1986, that volume had risen to $147.3 billion. Public Securities Association, *Munici-*

[1] A general summary of some of the salient characteristics of this particular capital market is set forth in the Report of Special Master Samuel J. Roberts (the "Report") submitted to the Court on January 22, 1987 and in the underlying Transcript and Stipulation of Facts. PSA members are also active participants in other public securities capital markets including United States government and Federal Agency securities, as well as mortgage-backed securities.

pal Market Developments (1987). These increased borrowing needs can be met only if State and local issuers can rely upon ready market access to obtain funds at a reasonable cost. That access is affected by the perceptions that other market participants have of State and local issuers as independent governmental entities operating in a federal system.

The municipal bond market has existed since the Colonial Period, and has grown and evolved over the same period of history during which the principles of federalism raised in this case have been formed and applied. It is a specialized market, largely separated from other capital markets serving the private sector, the federal government and other borrowing entities. It has developed and grown in response to State and local governmental borrowing needs and is responsive to the particular issuing constraints and requirements of State and local governmental issuers. *See generally* L. Chernak, *The Law of Revenue Bonds* (1954).

During its modern history, the municipal bond market has been marked by two signal characteristics. First, since the late nineteenth century, the market has enjoyed high investor confidence because of its stability and liquidity, and the repayment reliability of State and local governmental issuers. That hallmark of stability and reliability had not always prevailed and the efforts of this Court were required to restore it during the period following the Civil War. *See* VI C. Fairman, *History of the Supreme Court of the United States* 918-1101 (1971). The second signal characteristic is that municipal bond interest, as confirmed in the landmark decision of this Court in *Pollock v. Farmers' Loan and Trust Co.*, 157 U.S. 429 (1895), is exempt from federal income taxation.

The principles potentially at issue in this case are of vital importance to the maintenance and continuation of a stable, efficient and orderly municipal bond market. Investor confidence in the municipal bond market has always been premised on the sovereign status of State and local issuers. An essential element of that sovereign status is the constitutional protection from taxation, based on the doctrine of intergovernmental tax immunity, afforded the interest payable on municipal bonds. From a market perspective, that doctrine is not an abstract or formalistic concept. Rather, the doctrine assured investors that the municipal bond contract made by a State or local governmental issuer cannot be limited or affected by federal income taxation or by intrusive federal regulatory intervention. The fragility of investor reliance is not speculative and it cannot be overestimated. For example, in 1986, Senator Packwood brought municipal bond trading to a virtual halt simply by making statements concerning theoretical changes in the federal tax treatment of municipal bonds.[2]

Because of the importance of the issues raised to the stability and efficiency of the municipal bond market, PSA submits this *amicus* brief in support of the plaintiff, the State of South Carolina, and the plaintiff-in-intervention, the National Governors' Association.

STATEMENT OF THE CASE

PSA endorses and adopts the Statements of the Case and Statements of Facts set forth in the briefs filed by South Carolina and the National Governors' Association.

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[2] *See, e.g.*, Wall St. J., Mar. 20, 1986, at 47, col. 1.

SUMMARY OF ARGUMENT

The registration requirement imposed by Section 310(b)(1) of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA")[3] is not a tax, but is intended to regulate the behavior of the States and exact a penalty for noncompliance. Accordingly, the proper constitutional analysis tests the statute under the Tenth Amendment. Section 310(b)(1) is unconstitutional because it is an attempt by Congress to regulate an essential sovereign function reserved to the States and it imposes an impermissible regulatory penalty to enforce compliance.

South Carolina also challenges the constitutionality of Section 310(b)(1) under the Sixteenth Amendment and the doctrine of intergovernmental tax immunity, but it is unnecessary for the Court to reach these constitutional issues to resolve this case.

In the event the Court determines it must consider the tax immunity issues, it should apply *Pollock v. Farmers' Loan and Trust Co.*, 157 U.S. 429 (1895), to invalidate Section 310(b)(1). The rationale of *Pollock* and intergovernmental tax immunity is soundly based in constitutional principles of federalism. Because the registration requirement directly interferes with the States' sovereign power to borrow, Section 310(b)(1) violates the doctrine of intergovernmental tax immunity. Moreover, Section 310(b)(1) is not authorized by the Sixteenth Amendment.

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[3] Pub. L. No. 97-248, § 310(b)(1), 96 Stat. 596 (1982) (codified at 26 U.S.C. §§ 103(b)(3), 149(a) (Supp. 1987)).

ARGUMENT

I. SECTION 310(b)(1) IS A DIRECT REGULATION OF THE STATES WHICH IS UNCONSTITUTIONAL UNDER A TENTH AMENDMENT ANALYSIS.

A. Section 310(b)(1) Is A Regulatory Penalty And Not A Tax.

TEFRA Section 310(b)(1) is a regulation that requires State and local governments to issue municipal bonds in registered form, and imposes, as a penalty for noncompliance with the regulation, a tax on interest paid on such bonds. Section 310(b)(1) was not intended to produce revenue and, as the Special Master found, has not done so; "[r]ather, it functions as the linchpin of a regulatory scheme designed to insure that all publicly sold debt securities be issued exclusively in registered form." Report at 34. Justice Blackmun, in an earlier opinion in this case, found "evident" that it was not the purpose of Section 310(b)(1) "to produce revenue." *South Carolina v. Regan*, 465 U.S. 367, 384 (1984) (Blackmun, J., concurring). Since its enactment, all State and local obligations have been issued in registered form. Thus, Section 310(b)(1) has been supremely effective in accomplishing the regulatory purpose Congress intended. Consequently, Section 310(b)(1), far from being a tax, is a regulation that violates, as shown below, Tenth Amendment federalism principles by intruding upon the sovereignty of the States.

Congress cannot escape scrutiny of the constitutionality of an enactment by denominating a regulation as a tax. The Court has on several occasions declared invalid the penalty provisions in tax statutes that seek to ensure compliance with a regulation concerning activities beyond the federal power to regu-

late.[4] *United States v. Kahriger*, 345 U.S. 22, 31 n.10 (1953) (and cases cited therein), *overruled on other grounds, Marchetti v. United States*, 390 U.S. 39 (1968). In *United States v. Constantine*, 296 U.S. 287, 292-96 (1935), the Court invalidated a purported excise tax on retail liquor traffic that had as its only purpose the imposition of additional penalties for violations of State law. The exorbitant amount exacted by the purported tax demonstrated conclusively the purely regulatory intent underlying the statute. The statute violated Tenth Amendment principles because it intruded upon the States' rights to impose sanctions for violations of State law, which is reserved to the States by the Constitution. Thus, an area in which the federal government cannot intrude directly could not be reached indirectly by styling a regulation as a tax. *See also Child Labor Tax Case*, 259 U.S. 20 (1922); *Hill v. Wallace*, 259 U.S. 44 (1922). In these cases, the penalty provisions concerned activities reserved to the States to regulate. The registration re-

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[4] The Special Master cites *Veazie Bank v. Fenno*, 75 U.S. (8 Wall.) 533 (1869), for the proposition that a purely regulatory tax can be sustained as a means of implementing another delegated power. Report at 189. In *Veazie Bank*, the tax was imposed on a state-chartered bank pursuing purely private activities, *id.* at 547-48, and was actually collected by the Collector of Internal Revenue. *Veazie Bank* thus is distinguishable because the tax in that case sought to regulate purely private, rather than State, activities and was actually imposed and collected. Moreover, *Veazie Bank* recognized the principle that the broad language of the federal taxing power cannot be used to invade the rights of the States reserved under the Tenth Amendment. *Id.* at 547. *See also* Report at 95. Consequently, that case does not support imposition of a purported tax purely for regulatory purposes, such as Section 310(b)(1).

quirement goes further and regulates the conduct of the States in the exercise of a sovereign activity.

The fact that the putative tax in this case is used to enforce a federal regulatory scheme does not establish its validity, particularly where it fails to generate any revenue. The Court has upheld tax provisions imposed upon noxious goods or activities where the accompanying regulations are designed to enforce compliance with the related tax provisions and the tax actually generated revenue. *E.g., Kahriger*, 345 U.S. 22 (registration requirement for persons engaged in wagering and accompanying occupational tax held valid); *United States v. Sanchez*, 340 U.S. 42, 44 (1950) (Court considered attack on "regulatory character and prohibitive burden" of tax on transfer of marijuana); *Sonzinsky v. United States*, 300 U.S. 506, 512-14 (1937) (Court considered whether "statute contain[ed] regulatory provisions related to a purported tax . . . that . . . is a penalty resorted to as a means of enforcing the regulations"); *United States v. Doremus*, 249 U.S. 86 (1919) (regulatory provisions were designed to enhance collection of tax to which they were reasonably related and which was a true tax that generated revenue). Whether a purported tax is a valid exercise of the taxing power with the necessary accompanying regulatory effect as opposed to an invalid penalty depends fundamentally upon whether the tax was intended to obtain revenue. *Sonzinsky*, 300 U.S. at 514. As indicated above, Congress did not intend that Section 310(b)(1) would raise revenue and, as the Special Master found, it has not produced any revenue. Since Section 310(b)(1) does not impose a tax, its regulatory aspect is, by definition, unrelated to it. Section 310(b)(1), therefore, is

not a valid exercise of the taxing power.[5]

B. Section 310(b)(1) Is Invalid Under The Tenth Amendment Because It Is Overly Intrusive Of The Reserved Powers Of The States.

In Section 310(b)(1), Congress purports to impose a tax on the States' issuance of bearer bonds, while the intent and effect of Section 310(b)(1) is solely to regulate an area reserved to the States under our constitutional system. It is beyond dispute that protection of State sovereignty within our system of federalism was a vital consideration in the creation of the national government. *See Garcia v. San Antonio Metropolitan Transit Authority*, 469 U.S. 528, 550-51 (1985); *id.* at 568-70 (Powell, J., dissenting); *id.* at 580-82 (O'Connor, J., dissenting). "Our Federalism" recognizes that the States as sovereign entities have legitimate interests separate from those of the national government. Our constitutional system is designed to safeguard the States from an overbearing Congress. The diffusion of power and responsibilities between the national government and the States ensures the continued existence of a vital republic responsive to the needs of its citizenry. *Id.*

The constitutional system of federalism upon which this country was founded, and upon which its contin-

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[5] The Special Master suggests in his analysis that even if Section 310(b)(1) is not a valid regulation in aid of the taxing power it may still be sustained under the commerce power. Report at 128, 190. Congress has not attempted in Section 310(b)(1) to regulate interstate commerce in bearer bonds by, for example, prohibiting their transportation across State lines. This Court should not speculate as to the form and substance of such a hypothetical regulation, particularly when such a regulation could well be less intrusive on the States' sovereignty.

ued existence depends, relies upon the continued respect of the federal government for the reserved powers of the States. As demonstrated by the National Governors' Association, whose argument we support and adopt, the decisions of this Court consistently recognize the importance of safeguarding the States from intrusive federal regulation. *E.g., Garcia*, 469 U.S. at 555-56 (the constitutional structure imposes affirmative limits on federal action); *FERC v. Mississippi*, 456 U.S. 742, 761 (1982) ("the power to make decisions and to set policy is what gives the State its sovereign nature"); *Fry v. United States*, 421 U.S. 542, 547 n.7 (1975) (the Tenth Amendment expresses the constitutional postulate that Congress may not exercise its power to impair the States' integrity). In *Younger v. Harris*, 401 U.S. 37 (1971), the Court relied on federalism principles to hold that, under certain circumstances, federal courts must refrain from intruding on the right of a State to enforce its own laws. While *Younger* concerned intrusion by the federal judiciary, as opposed to the federal legislative branch, it is founded on the principle that States as independent sovereigns must have the ability to perform certain functions free from federal interference.

Although Section 310(b)(1) purports to impose a tax on the issuance of bearer bonds, Congress actually seeks to regulate the States' exercise of their borrowing power. This regulation intrudes in an area clearly reserved to the States in our constitutional system of federalism and thus plainly violates the Tenth Amendment. Section 310(b)(1) is not a valid tax because it is not designed to produce any revenue and in fact fails to do so. Instead, it is a penalty

enacted solely to force the States to comply with a regulation that intrudes on a sovereign activity reserved to the States by the Tenth Amendment.

II. THE COURT NEED NOT READDRESS THE INTERGOVERNMENTAL TAX IMMUNITY PRINCIPLES ESTABLISHED IN *POLLOCK*.

This Court has sustained tax regulations only where an actual tax was imposed and the challenged regulations were designed to enhance collection of the particular tax. It has not sustained a putative tax imposed by the federal government solely as a penalty to force compliance with a regulation, and it should not do so here, where the regulated activity involves the exercise by State and local governments of their borrowing power. This case can and should be decided on that basis and there is no need to reach intergovernmental tax immunity.

Pollock v. Farmers' Loan and Trust Co., 157 U.S. 429 (1895), has stood for over 90 years as a firm holding of this Court. It has continuously provided protection from federal tax intrusion to one of the most important sovereign functions of the States. The principles established by the *Pollock* holding are a core aspect of federalism at least as important as the location of a State capitol, *Cf. Coyle v. Smith*, 221 U.S. 559 (1911), and should not lightly be reexamined. If Section 310(b)(1) of TEFRA were a federal revenue-generating measure, the *Pollock* holding would be directly implicated. Revenue production is not, however, the purpose or intent of the registration requirement. *See South Carolina*, 465 U.S. at 384 (Blackmun, J., concurring). The Special Master readily acknowledged that the *Pollock* holding is not a subject for reexamination in this case. Report at 143-44, 184

n.486. Furthermore, he concluded that the record has not been developed in a manner to permit such reexamination.

Contrary to the Special Master's analysis, it is unnecessary to address the intergovernmental tax immunity issue at all since the case can be resolved on Tenth Amendment grounds. A fundamental tenet of constitutional decisionmaking is that questions unnecessary to the decision in a particular case will not be addressed. Indeed, Justice O'Connor's concurrence in granting South Carolina leave to file its complaint in this case stated, "it is this Court's longstanding practice to avoid resolution of constitutional questions except when absolutely necessary." *South Carolina*, 465 U.S. at 398 (O'Connor, J., concurring). From that general rule, the Court has developed specific principles of constitutional adjudication that direct against consideration of the tax immunity issue. Justice Brandeis' oft-cited concurrence in *Ashwander v. Tennessee Valley Authority*, 297 U.S. 288, 345-48 (1936) (Brandeis, J., concurring), is probably the most succinct analysis of the principles of constitutional decisionmaking.[6] Justice Brandeis restated the principles and proceeded to develop a "series of rules" for applying them. *Id.* at 345-47. These principles suggest that the Court should be reluctant in this case to revisit intergovernmental tax immunity. First, reexamining the

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[6] One scholar described this opinion as representative of "one of the truly major themes in Brandeis' judicial work: the conviction that the Court must take the utmost pains to avoid precipitate decision of constitutional issues, and that it must above all decide such issues only when it is absolutely unable otherwise to dispose of a case properly before it." A. Bickel, *The Least Dangerous Branch* 2-3 (1962).

tax immunity issues would "anticipate" a question of constitutional law because no tax has been imposed here.[7] *Id.* at 346-47. Second, a decision on those grounds would be far " 'broader than is required' " by the facts of this case, which may be disposed of on the narrower, more fact-specific Tenth Amendment grounds. *Id.* at 347 (citation omitted).

Clearly, a "rule of constitutional law" founded on the Tenth Amendment is the narrowest ground upon which to decide this case. Substantially all of the evidentiary presentation of the plaintiff and the Secretary focused on such Tenth Amendment issues as the nature of the intrusion on State sovereignty visited by compliance with Section 310(b)(1) of TEFRA, the federal objectives sought to be achieved by the regulatory provision and the legislative process pursuant to which Section 310(b)(1) was enacted. The developed record contains classic Tenth Amendment factual analysis and is largely irrelevant to the Sixteenth Amendment and intergovernmental tax immunity issues. Deciding this case on those latter grounds would be inconsistent with the Court's historical practice in constitutional jurisprudence. *E.g.*, *Crowell v. Benson*, 285 U.S. 22, 62 (1932).

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[7] This issue would be directly presented by a challenge to provisions of the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085. For example, the alternative minimum tax as it affects municipal bonds or the inclusion of municipal bond interest in determining the tax on Social Security benefits would directly raise the issue. *See* 26 U.S.C. § 86. Cases under these statutes may well be presented to this Court. Indeed, one such case has already produced a petition for certiorari. *Goldin v. Baker*, 809 F.2d 187 (2d Cir. 1987), *petition for cert. filed*, 55 U.S.L.W. 3714 (U.S. Apr. 10, 1987) (No. 86-1647).

In measuring the constitutional validity of Section 310(b)(1), it should be seen and assessed for what it plainly is—a regulatory penalty and not a tax. The Court's careful practice in confronting constitutional decisionmaking should be followed in this case to avoid an unnecessary and premature reexamination of the intergovernmental tax immunity principles established in *Pollock*.

III. THE DOCTRINE OF INTERGOVERNMENTAL TAX IMMUNITY PROHIBITS APPLICATION OF THE TAX SANCTION OF SECTION 310(b)(1).

If the Court addresses the doctrine of intergovernmental tax immunity in this case, it should hold that *Pollock v. Farmers' Loan and Trust Co.*, 157 U.S. 429 (1895), precludes the application of the threatened tax under Section 310(b)(1) of TEFRA. The Special Master's Report confuses, and in some part obfuscates, the relevant facts, the applicable law, and the constitutional imperative of federalism reflected in *Pollock*.

Contrary to the Special Master's recommendation, *Pollock* renders unconstitutional the imposition by the federal government of any tax on the issuance of a State debt obligation. This Court has consistently recognized the validity of intergovernmental tax immunity and the importance of that doctrine to the sovereign existence of the States in our dual system of government. *E.g., Massachusetts v. United States*, 435 U.S. 444, 454-60 (1978) (opinion of Brennan, J.); *New York v. United States*, 326 U.S. 572, 589 (1946) (Stone, C.J., concurring); *Helvering v. Gerhardt*, 304 U.S. 405, 414 (1938); *Metcalf & Eddy v. Mitchell*, 269 U.S. 514, 523-24 (1926). The Special Master's proposed modern synthesis of intergovernmental tax im-

munity breaks with all precedent by suggesting that no area of State sovereignty is free from taxation by the federal government if such a tax is nondiscriminatory, if the impact of the tax does not threaten the continued existence of the States and if the tax does not unduly interfere with the States' ability to perform essential government functions. Report at 181. The Report fails totally to account for the history of bearer bonds as the universal means of State and local borrowing, the continued vitality of *Pollock*, and the Sixteenth Amendment's nonapplicability to interest on State and local debt.

A. The Tradition Of Bearer Bond Financing.

From their genesis, State and local governments have issued bearer bonds, a practice drawn from commercial finance practices in England. *Cf.* Bouveier's Law Dictionary at 694 (Rawle's 3d Rev. 1914). State and local governments exercised their borrowing power through the issuance of bearer bonds long before there was ever a federal income tax. Bearer bonds have a purpose wholly independent of any tax laws in that they place in the hands of the holder the independent ability to receive interest promptly and transfer ownership quickly, simply and inexpensively. *Cf. Aurora City v. West*, 74 U.S. (7 Wall.) 82, 105 (1868); *Benwell v. Newark*, 55 N.J. Eq. 260, 36 A. 668 (1897).

Until TEFRA, State and local governments, in the exercise of their sovereign functions of borrowing for public needs, universally used the bearer bond form of borrowing. Since the effective date of Section 310(b)(1), however, all State and local government bonds have been issued in registered form. TEFRA

thus caused a complete reversal in State and local government practice.[8] Report at 23-24.

The ability of State and local governments to borrow money, in the manner and in the capital market that they choose, is a fundamental aspect of their sovereignty and is inherent in and necessary for their independent existence. That fundamental borrowing power existed before the States and their citizens devised that compact among the States, the Constitution. Surely no State ratifying the Constitution contemplated that it was authorizing the federal government to dictate its borrowing practices. Moreover, that borrowing power existed unimpeded by federal regulatory or tax measures when the States ratified the Sixteenth Amendment to enable the federal government to levy a direct, non-apportioned income tax. The Sixteenth Amendment did not expand the reach of the federal taxing power to authorize the levy of a federal income tax upon State and local interest on debt obligations.[9]

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[8] The universal compliance by State and local governments demonstrates conclusively that the penalty for non-compliance—a threatened tax on interest income—would be a severe and direct burden on the exercise of the sovereign power to borrow money for public purposes. Undisputed evidence before the Special Master proved that such a tax, if imposed, would increase interest costs to State and local governments by 28 percent to 35 percent. Transcript at 443, 618. This establishes that the imposition of this tax on a State and local governmental issuer who chose to issue bearer bonds would be a tax upon its sovereign authority to exercise its borrowing power. Moreover, more than increased borrowing costs would likely result since such issues would no longer have access to the same capital market.

[9] *See Metcalf & Eddy*, 269 U.S. at 521; discussion of the legislative background of the ratification of the Sixteenth Amendment, *infra*, at 27.

Throughout the history of the nation, State and local governments borrowing for their needs have been, by longstanding interpretation of the Constitution, free from federal taxation. The Secretary and the Special Master rewrite fact and history when they imply that the immunity of municipal bonds from federal taxation stems from any sort of conditional grant or benefit from the federal government. Report at 78, 126-28. Nor is there any basis for the Special Master's suggestion that Section 310(b)(1) "merely alters the economic calculus" underlying the States' choice of debt issuance. *Id.* at 126. The exemption from federal income tax of interest paid on State and local debt is grounded firmly in the Constitution. Nothing before or after *Pollock* has altered that fundamental truth.

B. *Pollock* Requires The Court To Invalidate Section 310(b)(1).

The doctrine of intergovernmental tax immunity was recognized by this Court in *M'Culloch v. Maryland*, 17 U.S. (4 Wheat.) 316 (1819), which held unconstitutional a tax imposed by the State of Maryland on a bank chartered by Congress. Shortly thereafter, in *Weston v. City Council of Charleston*, 27 U.S. (2 Pet.) 449, 481 (1829), this Court specifically held that one sovereign government could not constitutionally tax the obligations of another sovereign. Chief Justice Marshall's opinion for the Court in *Weston* reiterated Hamilton's observation in The Federalist that our federal system, in which more than one sovereign is charged with public responsibilities (and each is given an attendant power to raise revenue), "might require reciprocal forbearances." A. Hamilton, *The Federalist No. 32* 202 (J. Cooke ed. 1961). Finally, in *Pollock*,

the Court ruled unconstitutional the federal Revenue Act of 1894, which imposed a federal tax on the interest paid on State debt obligations. 157 U.S. at 586. In expressly holding that such interest was constitutionally immune from federal income taxation, the Court stated:

> the tax in question is a tax on the power of the States and their instrumentalities to borrow money, and consequently repugnant to the Constitution.

Id. *Pollock* is the only Supreme Court case ever to consider the validity of the imposition of federal income tax on municipal bond interest. As it pertains to that issue, *Pollock* remains sound law and forms an essential basis for the participation of State and local governments in the municipal bond market.

Notwithstanding the Special Master's interpretation to the contrary, Report at 164-81, this Court has never wavered in its recognition that intergovernmental tax immunity is a basic concept of constitutional magnitude, founded on fundamental principles of federalism and the concomitant respect of one sovereign for another. The constitutional purpose of tax immunity since its inception has remained constant: "to protect the States from undue interference with their traditional governmental functions." *Massachusetts*, 435 U.S. at 459. The "undue interference" from which States are protected need not be particularly burdensome or threatening so long as it is the State being taxed because it is taxation of the State that infringes State sovereignty and offends constitutional notions of federalism. *New York*, 326 U.S. at 587

(Stone, C.J., concurring).[10]

While the Court has consistently adhered to the rationale of intergovernmental tax immunity, the precise contours of a sovereign's "government functions" are not clearly defined. *See New York*, 326 U.S. 572. The Special Master, however, did not even attempt to determine how the contours of intergovernmental tax immunity fit this case. Instead, the Special Master proposed a new test for application of the doctrine:

> To prevail on their claim that the tax sanction violates the State's constitutional tax immunity, plaintiffs must show that the sanction operates to discriminate against the States. Failing that, plaintiffs might still prevail if they could demonstrate that the actual impact of the sanction threatens the continued

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[10] The threatened tax imposed by Section 310(b)(1) would clearly fall directly on the States. The financial markets of today offer a plethora of choices to investors who can move their money from one investment to another very rapidly, even daily or overnight. The imposition of a tax on interest on municipal bonds is not a tax upon investors, for they can immediately change their investments, demanding and readily obtaining higher interest on other taxable investments. Thus, it would be a tax on the borrowing power of the States and local governments. That makes this case unlike every previous case in which this Court has disallowed the claim of immunity voiced by the third party recipient of payments from the States and local governments. Even greater proof of the impact of such legislation on the sovereign power to borrow is the fact that the States and local governments did not view the sanction in Section 310(b)(1) as a tax that some third party would have to bear. Rather, these governments reacted (as intended by Congress) by changing their centuries-old mode of borrowing from bearer to registered bonds to avoid the imposition of the threatened tax on them.

> existence of the States or inerferes [*sic*] unduly with their ability to perform essential government functions.

Report at 181. The Special Master's proposed test emasculates tax immunity by effectively providing that no area of State sovereignty is free from federal taxation. Such a result ineluctably offends constitutional notions of federalism as reflected in *Pollock*, which held that the borrowing power is a central attribute of State sovereignty in our constitutional framework and recognized that interference with that power by the federal government is direct and immediate. There is no need to develop a new, theoretical constitutional standard. The decisions of this Court that the Special Master considers to have undermined *Pollock* did no such thing. These decisions either expressly endorsed *Pollock* or explicitly recognized its rationale of direct interference.

In *Metcalf & Eddy v. Mitchell*, 269 U.S. 514 (1926), the Court upheld the application of federal tax to the income of an independent contractor performing work for States and political subdivisions. The Court nevertheless emphasized that intergovernmental tax immunity protects against interferences with the sovereign powers of State and local governments, stating that debt obligations of State and local governments "sold to raise public funds . . . [are] so intimately connected with the necessary functions of government, as to fall within the established exemption; and when the instrumentality is of that character, the immunity extends not only to the instrumentality itself but to income derived from it." *Id.* at 522 (citing *Pollock*). Although *Metcalf & Eddy* dealt with a general tax not intended to affect the

way the States and local governments conducted their affairs, the Court reasoned that the subject of a tax "may be of such a character or so intimately connected with the exercise of a power or the performance of a duty by one government, that any taxation of it by the other would be such a direct interference with the functions of government itself as to be plainly beyond the taxing power." *Id.* at 524.

Similarly, in *Willcuts v. Bunn*, 282 U.S. 216 (1931), the Court held that the profit from the sale of municipal bonds by an investor could constitutionally be taxed by the federal government. The Court recognized that it is not necessary to protect States against nondiscriminatory federal taxes "where no direct burden is laid upon a governmental instrumentality, and there is only a remote, if any, influence upon the exercise of the functions of government."[11] *Id.* at 225. The Court again cited *Pollock* in contrasting the tax exemption for the principal and interest on State and local bonds because "a tax upon the amounts payable by the terms of the contract has therefore been regarded as bearing directly upon the exercise of the borrowing power of government." *Id.* at 226. The Court found nothing in the record or any basis for judicial notice that the tax on the profit from the sale

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[11] Apparently it is language such as that in *Willcuts* requiring a showing of a substantial burden to invalidate a tax that was seized upon by the Special Master in formulating his proposed standard. *See* Report at 166-67. However, the substantial burden requirement of *Willcuts* was imposed because the taxed transaction was substantially removed from the exercise of the States' borrowing power. Since there was no *direct* interference in the contract by the federal government, the Court properly required a higher showing to invalidate the tax.

of the bonds effected the exercise of the borrowing power of the issuer, *id.* at 230-34, and it was plain that the States and local governments were not asserting any such claim.[12]

In *Helvering v. Gerhardt*, 304 U.S. 405 (1938), the Court denied the claim of an employee of a political subdivision that his compensation was immune from federal income taxation. The Court noted that it would not recognize "immunity when the burden on the state is so speculative and uncertain that if followed it would restrict the federal taxing power without affording any corresponding tangible protection of state government . . . ." *Id.* at 420. The Court reasoned that tax immunity in such cases would secure to States "a theoretical advantage so speculative in its character and measurement as to be insubstantial." *Id.* at 421. By contrast, the Court reaffirmed that

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[12] *See also James v. Dravo Contracting Co.*, 302 U.S. 134 (1937), which held that the income of a federal contractor from its federal contract was not immune from State tax. In distinguishing *Pollock*, the Court said: "There is no ineluctable logic which makes the doctrine of immunity with respect to government bonds applicable to the earnings of an independent contractor rendering services to the Government. That doctrine recognizes the direct effect of a tax which 'would operate on the power to borrow before it is exercised.' " *Id.* at 152-53. Similarly, the Court rejected a private lessee's claim to immunity of income from a lease with a State agency in *Helvering v. Mountain Producers Corp.*, 303 U.S. 376 (1938). The Court noted that *Pollock* exempts income of third parties because a tax on municipal bond income is "a tax bearing directly upon the exercise of the borrowing power of the Government . . ." but noted that "immunity from nondiscriminatory taxation sought by a private person . . . cannot be supported by merely theoretical conceptions of interference with the functions of government." *Id.* at 386.

interest income from municipal bonds was immune from taxation because "the function involved [borrowing money] was one thought to be essential to the maintenance of a state government." *Id.* at 417.

Graves v. New York, 306 U.S. 466 (1939), the mirror image of *Gerhardt*, denied immunity claimed by employees of a federal agency from state income taxation. Again, the Court emphasized that the purpose of immunity is not to provide benefits to third parties "but to prevent undue interference with the one government by imposing on it the tax burdens of the other." *Id.* at 483-84.

Inexplicably, the Special Master interpreted the foregoing cases as undermining *Pollock*, notwithstanding that the Court repeatedly cited *Pollock* with approval. In those cases, the Court was merely defining the broad parameters of intergovernmental tax immunity to preclude payments to third parties where the effect on the governmental body was theoretical and speculative. Not only did those cases fail to impair *Pollock*, they reaffirmed its soundness.

More modern cases have dealt with the intergovernmental tax immunity issue more tangentially, but still support the continued vitality of *Pollock*. In *New York v. United States*, 326 U.S. 572 (1946), the Court held that a nondiscriminatory federal excise tax on mineral waters sold in containers could constitutionally be applied to the sale of mineral waters by a State. A plurality of the Court reaffirmed the doctrine of intergovernmental tax immunity by rejecting any thesis that it does not apply to nondiscriminatory taxes, because "it is plain that the invalidity is due wholly to the fact that it is a State which is being taxed so as unduly to infringe, in some manner, the

performance of its functions as a government which the Constitution recognizes as sovereign." *Id.* at 588 (Stone, C.J., concurring). Justice Frankfurter concurred in the judgment and acknowledged that certain State activities, such as levying taxes and owning a statehouse, "could not be included for purposes of federal taxation in any abstract category of taxpayers without taxing the State as a State." *Id.* at 582 (Frankfurter, J., concurring). The practical impact of permitting the federal government to intrude upon State sovereignty is to remove the principle of federalism from the Constitution:

> "[t]he Constitution is a compact between sovereigns. The power of one sovereign to tax another is an innovation so startling as to require explicit authority if it is to be allowed. If the power of the federal government to tax the States is conceded, the reserved power of the States guaranteed by the Tenth Amendment does not give them the independence which they have always been assumed to have. They are relegated to a more servile status. They become subject to interference and control both in the functions which they exercise and the methods which they employ. They must pay the federal government for the privilege of exercising the powers of sovereignty guaranteed them by the Constitution, whether, as here, they are disposing of their natural resources, or tomorrow they issue securities or perform any other acts within the scope of their police power."

Id. at 595 (Douglas, J., dissenting) (footnote omitted).

Most recently, in *Massachusetts v. United States*, 435 U.S. 444 (1978), the Court held that a federal nondiscriminatory aircraft registration tax, in the nature of a user fee, could be levied on State aircraft without infringing the intergovernmental tax immunity doctrine. In reviewing the history of the tax immunity doctrine, Justice Brennan's plurality opinion focused on the constitutional purpose of the doctrine: "to protect the States from undue interference with their traditional governmental functions." *Id.* at 459. That purpose remains a vital part of our constitutional tradition, yet would be utterly vitiated by the Special Master's supposedly modern formulation. There is no support in any of these cases for this Court to conclude, as the Special Master has, that intergovernmental tax immunity protection does not prohibit the threatened tax of Section 310(b)(1).

In unnecessarily striving for new theoretical concepts, the Special Master propounds at least eight different formulations of the basis for judicial intervention under intergovernmental tax immunity (Report at 146, 147, 168, 171, 173, 175, 177, 181), ranging from requiring that the federal tax have a "substantial and direct effect upon governmental functioning" (*id.* at 171) to that it "cripple State autonomy" (*id.* at 146 n.440). In applying legal analysis to the case, however, the Special Master consistently applies an unreasonably harsh standard—"danger to the States' continued existence" (*id.* at 181-82), "threatening the continued existence of the States as governmental entities" (*id.* at 182), "destructive of their independent existence" (*id.* at 184). This "Armageddon test" would utterly vitiate the doctrine of intergovernmental tax immunity and is not supported

in any manner by the opinions of this Court that the Special Master purportedly relied upon.

The Special Master's approach to tax immunity also smacks more of abstract formalism than of practical reality. If the registration requirement—or any other section or subsection of federal tax legislation—must "threaten the continued existence" of fifty States and their 47,000 subdivisions before it warrants constitutional scrutiny under the intergovernmental tax immunity doctrine, then that doctrine and important federalism principles behind it are dead letters. As one constitutional scholar has observed:

> Of course, no one expects Congress to obliterate the states, at least in one fell swoop. If there is any danger, it lies in the tyranny of small decisions—in the prospect that Congress will nibble away at state sovereignty, bit by bit, until someday essentially nothing is left but a gutted shell.

L. Tribe, *American Constitutional Law* § 5-20 (1978).

The Special Master's new formulation of tax immunity is not correct. Time-honored precedents demonstrate plainly that the incursion by Congress in Section 310(b)(1) goes too far. In the light of the facts here, where the threatened tax would clearly, directly and intentionally impact the borrowing power of the States and local governments, *Pollock* mandates that Section 310(b)(1) is unconstitutional. To ignore that and uphold Section 310(b)(1) on the basis of the totally unsupported assumption that such a burdening of the States and local governments in their sovereign functions will further federal tax compliance would eviscerate fundamental principles of federalism. The

enactment of Section 310(b)(1) is a breach of faith with the States under the compact that is our Constitution.

C. The Sixteenth Amendment Does Not Authorize A Tax On The Interest Paid On State And Local Debt.

Finally, PSA fully supports the analysis set forth in the brief of *amicus curiae*, Government Finance Officers Association, demonstrating that the Sixteenth Amendment excludes by the original intention of its Framers any power for Congress to levy a tax on State and local government debt obligations. Ratification of the Sixteenth Amendment was secured only after public assurances to the States by the sponsors of the Amendment that it would not authorize the taxation of municipal bonds. The assurances were given after Governor Hughes of New York had recommended against ratification for fear the Amendment contained such authority. *See* 45 Cong. Rec. 1694-98 (Feb. 10, 1910) (statement of Sen. Borah); 45 Cong. Rec. 2245-47 (Feb. 23, 1910) (statement of Sen. Brown). Before February 10, 1910 and such reassuring representations, only two States had ratified the Sixteenth Amendment. U.S.C.A. Const. Amend. XVI (Historical Note). Surely, this ratification process, premised on an explicit understanding that the proposed amendment would not reach municipal bond interest, establishes that the scope of the Sixteenth Amendment is more narrow than the Special Master believed. Contemporaneous history and purpose are traditional guides to the interpretation of constitutional amendments. *Slaughter-House Cases*, 83 U.S. (16 Wall.) 36, 67-68 (1872). Thus, the Sixteenth Amendment affords no support for Section 310(b)(1).

The Special Master acknowledged that this Court has consistently held that the Sixteenth Amendment did not extend the scope of the federal taxing power. *See Metcalf & Eddy*, 269 U.S. 514. However, the Special Master characterizes the important interchanges between congressional and State political leaders as merely conversations reflecting the prevailing view of the intergovernmental immunity doctrine. Report at 163 n.463. His characterization unjustifiably diminishes the significance and importance of the understandings sought by and given to the States in connection with their ratification of the Amendment. *See Slaughter-House Cases*, 83 U.S. (16 Wall.) at 67-68.

CONCLUSION

The Court should resolve this case in favor of South Carolina under the principles of constitutional federalism embodied in the Tenth Amendment and on the basis that the tax sanction imposed by Section 310(b)(1) constitutes an impermissible penalty under those same principles. If the Court reaches the issue of the applicability of the doctrine of intergovernmental tax immunity, the Court should determine that Section 310(b)(1) unconstitutionally imposes a threatened tax on income derived from debt obligations issued by the States and their political subdivisions.

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